INTERNAL REVENUE SERVICE

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR DISTRICT COUNSEL

FROM: DEBORAH A. BUTLER
ASSISTANT CHIEF COUNSEL (FIELD SERVICE)

SUBJECT:

This Field Service Advice responds to your memorandum dated June 25, 1998. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

A =
B =
C =

D =
E =
F =
G =
H =
I =
J =
K =
L =

M =
N =
O =
P =
Q =
R =
S =
T =

$U =
$V =
$W =
$X =
$Y =
$Z =
$AA =
$BB =
$CC =
$DD =
$EE =
$FF =
$GG =
$HH =
$II =
$JJ =
$KK =
$LL =
$MM =
$NN =
$OO =
$OO2 =
$PP =
$QQ =
$RR =
$SS =
$TT =
$UU =
$VV =
$WW =
$XX =
$YY =

$ZZ =
$AAA =

$BBB =
$CCC =
$DDD =
$EEE =
$FFF =
$GGG =
$HHH =

III% =
JJJ% =

KKK =
LLL =
MMM =
NNN =

OOO days =

PPP months=
QQQ months =

RRR years =
SSS years =

YEAR 1 =
YEAR 2 =
YEAR 3 =
YEAR 4 =

DATE 1 =
DATE 2 =
DATE 3 =
DATE 4 =
DATE 5 =
DATE 6 =
DATE 7 =
DATE 8 =
DATE 8a =
DATE 9 =
DATE 10 =
DATE 11 =
DATE 12 =
DATE 13 =
DATE 14 =

DATE 15 =

ISSUES:

(1) Whether the sham transaction doctrine applies to this lease stripping transaction and would support disallowance of the taxpayer's claimed deductions for expenses?

(2) Is G a sham partnership?

(3) Whether I.R.C. § 269 applies to disallow the deductions claimed by M as a result of the lease stripping transaction described below.

(4) Whether the step transaction doctrine should be applied to the lease stripping transaction described below.

(5) What are the tax effects of the Guaranteed Income Agreement?

International will provide an analysis of section 482 in a separate memorandum.

CONCLUSIONS:

(1) The sham transaction doctrine applies to this transaction and would support the disallowance of the taxpayer's claimed deductions for expenses, and possibly for the amortized payments. We recommend developing additional facts to support this argument.

(2) The facts in this case support the conclusion that G is a sham partnership.

(3) If the Service is otherwise planning to attack the lease stripping transaction at issue, it may also argue that section 269 applies to disallow to N the deductions at issue.

(4) Exam mentions the step transaction doctrine, but does not specifically recommend applying this theory. Should the field wish to further develop the application of the step transaction doctrine, we would need to know exactly how the Field proposes to recharacterize the lease stripping transaction. In other words, we would need to know the specific steps that the Field believes occurred in substance.

(5) The GIA, when viewed as a part of the entire transaction, appears to possess neither business purpose nor economic substance and is a sham; however, additional facts should be developed concerning the GIA.

FACTS:

This case consists of a series of transactions that have created a mismatch between income and related deductions, resulting in a U.S. taxpayer, N, claiming deductions in the amount of $ZZ for the tax years YEAR 1 through YEAR 4.

The taxpayer, N, claimed a total of $ZZ, in rent paid and other deductions (amortization) for the YEAR 1, YEAR 2, YEAR 3 and YEAR 4 tax years. N reported a deduction for rent paid in the amount of $SS for YEAR 1, $TT in YEAR 2, and $RR in YEAR 3. N reported interest income from the investment instrument, the Guaranteed Income Agreement, in the amount of $GG in YEAR 1, $FF in YEAR 2, $DD in YEAR 3 and $U in YEAR 4. N reported taxable income of -$XX for the tax years YEAR 1 through YEAR 4. The taxpayer amortized over three years the $HH in initial rental payments which G, and subsequently M was to pay but had N pay on its behalf. N had deducted against income the amortization over three years of an intangible asset, the initial rental payments, in the amount of $HH, for an amortized amount of approximately $CC in YEAR 1, $BB in YEAR 2, and $AA in YEAR 3.

Exam has proposed that N's deductions for rental expenses paid be disallowed, and that the amortization of the unpaid initial rental payments should be disallowed.

STEP 1

A either purchased or leased the equipment from an unknown Dutch party. The original, underlying lease dated DATE 1, is between A, the lessor, and D, a subsidiary of E. According to the Lease Agreement, at 5, the equipment "shall at all times remain the sole and exclusive property of the Lessor (A)." A leased computer equipment to D in exchange for quarterly rent payments of $MM (originally denominated in British Pounds). E was the actual user of the equipment, but D was required to maintain insurance on the equipment. An equipment schedule was executed on DATE 2, and the lease was to end DATE 11, with a possible extension of RRR or SSS years.

Under the terms of the Lease Agreement, "The Lessor [A] shall let and the Lessee [D] shall hire the machines and features specified in the First Schedule." Lease Agreement, at 2. Following the delivery of the equipment, T was to install the equipment.

STEP 2

Eleven different leasing agreements or amendments were purportedly entered into in DATE 3. Many of the leases that are available were not executed.

1. Umbrella Agreement between A and F

Under the so-called "umbrella agreement," A acquired the use of the equipment as a lessee, and stated that it was going to sublease the equipment to F. F was required to pay A a fee of $X, in consideration for A's agreement to enter into the Lease Agreement with F. The umbrella agreement covered nine schedules of computer equipment, and it included the computer equipment that was already leased to D under Schedule 6 and Schedule 7. The taxpayer, N, acquired an interest the equipment listed in Schedules 6 and 7 only.

This agreement states, at 2, "No Rental shall be payable by F to A under Lease A and no Rental shall be payable by F to A under Lease B and all inconsistent provisions of such Leases (e.g., reference to a Discount Rate) shall be ignored."

Under the umbrella agreement, F was allowed to sublease the equipment; however, any sublessee could not prejudice A's rights under its leases.

2. A - F Lease A

In a separate agreement believed to have been entered into on the same day, A leased the computer equipment listed in Schedules 6 and 7 to F. Under the terms of the Lease Agreement, at 2, "The Lessor [A] shall let and the Lessee [F] shall hire the machines and features specified in the Equipment Schedule(s) from time to time forming part of this Lease 'AS IS and WHERE IS' and upon the terms and conditions set out herein." A assigned to F its rights as lessor under any third party leases. This lease did not require F to pay any rent, and was for PPP months.

3. F - A Lease B

F then subleased the equipment back to A under a separate Lease Agreement. As with Lease A, Lease B did not require any rent to be paid by A, it required no transaction fee, and was also for PPP months.

4. F - G Master Lease

At the same time that F leased the equipment from A, F leased the equipment to G, a UK partnership, for a term of QQQ months, from DATE 3, to DATE 14. Under the terms of the Lease Agreement, it was agreed that, "The Lessor [F] shall let and the Lessee [G] shall hire the machines and features specified in the Equipment Schedule(s) from time to time forming part of this Lease 'AS IS' and 'WHERE IS' and upon the terms and conditions set out herein." Lease Agreement, at 2.

Note that F had leased the equipment from A for only PPP months. G was to pay an initial rental payment of approximately $OO of which approximately $JJ (of which only a portion was ultimately paid) was to be paid for the equipment at issue

under Schedules 6 and 7, plus seven semiannual payments of approximately $PP. G was to pay approximately a total of $GGG, including the initial rental payment. These amounts were originally denominated in Deutschmark but converted into U.S. dollars for the purpose of this analysis because currency risk is not an issue. Although theoretically G was entitled to A's rental payments to F, G never received any rent payments from A, which was likely because the A-F leases did not require any rent.

The Lease Agreement "permits [G] to sublet the Equipment to B which [G] has done pursuant to a Lease Agreement entered into concurrently with the Lease ('the B Lease')." Lease Agreement, at 9.

Under this lease, G acquired rights that were subject to the rights of any existing encumbrance. Also, the lessor warranted that it acquired the rights of any preceding lessors under third party leases and assigned those rights to the lessee; thus, in theory each sublessee acquired the rights of A as lessor. This language appears in subsequent subleases between other parties, also.

This agreement did not provide for the prepayment of rent.

The F-G lease was executed in DATE 3. Subsequently, F assigned its right to receive income from G to K a UK financial intermediary; however, K paid no consideration for this assignment.

5. Amendment to Lease Agreement between F-G

The Amendment to the F-G lease was executed in DATE 3. The Amendment required payment of the initial rental amount within 10 days of the date of the Amendment, or by DATE 6, and gave F the right to terminate if it was not paid. This amount was unpaid as of the end of DATE 9, but F never enforced its right to terminate.

The Amendment acknowledges that G sublet the equipment to B. The Amendment states, "In order better to secure F's rights to recover the Equipment (in light of the execution of the B lease) G has assigned to F all its right and interest in the B Lease to F as provided in the Lease, such assignment becoming absolute on the premature termination for whatever reason of the Lease [between F and G]." Amendment to Lease Agreement, at 1.

6. G-B

G leased the equipment to B. This lease was to run for PPP months and required six semiannual rental payments in Swiss Francs, for a total of $CCC (originally denominated in Swiss Francs).

The agreement allowed for a prepayment of the rent. On DATE 5, B prepaid the rent due to G, approximately $CCC. It is believed that all of G's partners at this point were UK individuals, and none of G's partners filed returns in the U.S. G did not file a Form 1065 in the U.S.; thus, this income was untaxed in the U.S. G used these proceeds to purchase a Guaranteed Income Agreement ("GIA," discussed below) from K, as discussed below.

Under the Lease Agreement, the parties agreed that, "The Lessor [G] shall let and the Lessee [B] shall hire the machines and features specified in the Equipment Schedule(s) from time to time forming part of this Lease 'AS IS and WHERE IS' and upon the terms and conditions set out herein." Lease Agreement, at 2. Additionally, provided that B complies with its obligations as the lessee, B:

> shall have full rights of possession and quiet enjoyment of the Equipment through the Letting, subject to any subsisting liens or encumbrances, provided always that should the Lessor, or any superior lessor to the Lessor, have already leased any of the Equipment to a third party the Lessor hereby warrants to the Lessee that it has acquired, and hereby assigns absolutely to the Lessee, all right, title and interest of the Lessor and/or, as the case may be, of its immediate superior lessor, as lessor in and to such third party lease, subject to the condition that the Lessee shall not do or permit any wrongful interference with the rights of such third party lessee or any sublessee of such lessee to quiet enjoyment of the Equipment.

Lease Agreement, at 2.

Under the Lease Agreement, at 4, B is obligated to procure that equipment is in good working condition and good working order. B' only interest in the equipment is the right to the quiet possession and use of the equipment.

7. Amendment to G-B lease

In this Amendment, at 1, G assigned to B "any rights, if any, which G may have against F for the recovery of any unused prepaid rental or any other sums upon determination of the F-G lease," under the F-G lease, in exchange for B's waiver of any rights that it might have against G to recover prepaid rent under the G-B lease.

8. Lease Agreement B-F

B leased the equipment back to F for a term of PPP months. The total rental payments were $CCC (originally denominated in Swiss Francs) plus an initial rental payment of approximately $II (originally denominated in Deutschmark) but with no

transaction fee. F was to pay B a total amount of $FFF. The prepaid rent was to be discounted by III%, but there is no evidence whether F prepaid the rent due to B.

B assigned to F the rights that it may have against F for the recovery of prepaid rent under either the F-G lease or the G-B lease, in return for F's waiver of rights that it may have had against B to recover prepaid rent under the B-F lease.

9. Amendment to Lease Agreement between B-F

The Amendment acknowledges that B had leased the equipment from G and that B and G had entered into the Supplemental Rental Agreement (discussed below).

10. Supplemental Rental Agreement between B-G

On DATE 5, G and B entered into a Supplemental Rental Agreement ("SRA") which was to extend from DATE 4, through DATE 15. Under the SRA, B was to make additional payments to G in certain circumstances, and certain of G's rights would pass to B and back to A. Payments were made with reference to: (1) any rentals received by any S company from an end-user of the equipment after a given date, (2) the net sales proceeds received by any S company from the sale of the equipment after the given date, and (3) the notional sales value of the equipment if it is sold before a given date (i.e., the dates for releasing the equipment). Thus, the payments were to provide G with income from the residuals on the equipment, after the leases expired in YEAR 3. G could assign its right to receive supplemental rental to anyone, other than a competitor of B', without the prior written consent of B.

The SRA established a "Revenue Fund," a notional fund, to which B was to make credits for revenues received by a B group member. These credits were to be apportioned between B and G according to agreed-upon percentages. Credits were made to the fund for revenue received by any member of the B group from DATE 11, through DATE 15 (after the leases expired). Payments for rent under the SRA were based on revenues received by B or the B group through DATE 15.

B's obligation to pay the supplemental amounts was to survive the termination of the lease.

Supplemental rent was not to be paid unless and until B or a B group member received rents equal to a minimum sum. These minimum sums were to represent the present values of the net rentals from the date of receipt back to DATE 4, calculated at a discount rate of JJJ%.

The effect of this SRA is for the B group to pay part of the rentals it receives to G for the period from DATE 13, through DATE 15, in exchange for a share in the rentals from DATE 12, through DATE 13.

11. A Guaranteed Income Agreement from K to G

A Guaranteed Income Agreement ("GIA") was also executed on DATE 5. G used the prepaid rents that it received from B, approximately $CCC, on DATE 5, to purchase the GIA from K. G paid a fee to K in the amount of $W (originally denominated in Pounds), for this GIA. Under this GIA, K agreed to invest the funds from G and use them to pay the rent due to F under the G-F leases. K was obligated to disburse payments to F on behalf of G. K was apparently presented with rent schedules by F. However, when, if and how the money was disbursed is not entirely clear.

The incoming request for assistance states that, based on an analysis prepared by the taxpayer, it appears that K guaranteed an investment rate of III% to G, the same discount rate given to B for its prepayment of rent.

G signed an Instruction to K as of DATE 5, which provides, "In accordance with Clause 2(b) of the Agreement, we hereby irrevocably instruct you to make all payments due under the Agreement to discharge our obligations under the Rent Schedules referred to therein."

STEP 3

On DATE 8, N organized M, a wholly-owned subsidiary, by contributing an obligation to M for $V in exchange for MMM shares of stock in M. N did not apparently satisfy this obligation until DATE 10.

STEP 4

Two additional documents were executed on DATE 9.

1. Amendment to Lease and Supplemental Rental Agreements

This Amendment to Lease and Supplemental Rental Agreements ("Amendment to SRA") was to provide for additional payments from B to G based on certain revenues. The Amendment to SRA modified the lease between G and F of DATE 5, and the original SRA.

According to the Amendment to SRA, G failed to pay the initial rental of approximately $JJ. This was amended, and replaced with $HH, but this amount was never paid by G; rather, N eventually paid this amount on behalf of M

(discussed below). This Amendment also changed the original apportionment of the Revenue Fund.

2. Guaranty and Indemnification between C, A, B, and M

Under this Guaranty and Indemnification, A agreed to indemnify M for any deficiency on account of any breach by B or A.

STEP 5

On DATE 9, M acquired a partnership interest in G. M acquired certain assets from G in exchange for $Y in cash, KKK shares of stock in M, and the assumption of G's obligations under the F-G lease, the G-B lease, and the G-B Supplemental Rental Agreement. At the same time, N subscribed to an additional LLL shares of M for $KK. Thus, N held a total of NNN shares of M, and G held KKK shares in M. These transactions together purportedly constituted a section 351 transaction.

After the completion of these transactions, M was apparently obligated to make a: (1) $HH cash payment to satisfy G's initial rental payment to F; (2) $Z payment to Q, the promoter of this transaction, for its services; and (3) $Y payment to Q acting as agent for G. Thus, M's total obligations were $KK.

According to the Engineering and Valuation Report, at 8, N never paid the $KK to M, but rather made payments on behalf of M directly to the other parties to whom M was obligated.

STEP 6

On DATE 9, a series of "acknowledgment letters" were solicited by G and M from B, F and K. The letter from G and M to B advised B and sought the consent of B of G's assignments to M.

OTHER FACTS

R appraised the computer equipment, which the taxpayer pointed to as a legitimate business purpose or economic reality in the transaction. R appraised the residual value of the equipment as of DATE 11, in Schedule 6 to be $UU and in Schedule 7 to be $VV.

Q's first written contact with N occurred in a letter dated DATE 7. Q sent a letter to P of O, which is apparently the parent of N. This letter states, "In summary, an investment of $QQ in an initial lease payment provides pre-tax economics of $WW. In addition, please note that the transaction will produce net tax deductions of approximately $HHH over a three year period."

In the Summary of the Equipment Lease Transaction, Q claims that income tax deductions of $HHH at an effective tax rate of 34% will result in a U.S. company's tax savings of $EEE.

G had received income in the form of the prepayment of rent from B. G is a UK partnership, and two of the three partners, I and H, are UK residents and individuals. No information is known concerning the third partner, J. However, G did not file a form 1065 for any year in issue, and none of its partners filed returns in the U.S. for the years in issue.

N is claiming a deduction for rent expenses in the amount of $SS in YEAR 1, $TT in YEAR 2, and $RR for the YEAR 3 tax year, based on claimed expenses under the lease obligations that M assumed from G. However, neither N nor M actually paid any of these rent expense obligations; rather, the payments were made by K pursuant to the Guaranty Income Agreement that G had purchased (STEP 2, #11).

According to the Engineering and Valuation Report dated December 18, 1996, prepared by the Service, Boston District, N paid an initial fee of $KK (on behalf of M), paid rental payments pursuant to a lease in the amount of $AAA and received lease revenues in the amount of $AAA, resulting in a net paid amount of $KK. This Report concluded that the taxpayer would lose money on the transaction and never had any reasonable expectation of making any money as a reasonable person who was apprized of the relevant facts would recognize, and no prudent businessperson would have entered into this transaction with the expectation of financial gain.

The rent and amortization deductions are for YEAR 1 through YEAR 4.

In summary, G received prepaid rent from B, and paid it to K for the GIA. K agreed to pay "rent" on behalf of G to F, pursuant to the Rent Schedules that were presented to K by F. G was supposed to pay F rent in the amount of $DDD (through the GIA paid by K). F, in turn, was supposed to pay rent to B in the amount of $CCC. B was supposed to pay G rent in the amount of $CCC. It should be noted that F owed A no rent -- F had paid A only a fee in the amount of $X for the equipment.

Additionally, K and F are related through L. L, who is apparently a significant minority shareholder in K, is also a Managing Director and shareholder in F.

The circular flow of money pursuant to the leases and the GIA is as follows (beginning with the G-B lease because B had prepaid its rent to G):

	$	Fee	Initial Rental	Rents(total)	Total
B-G		0	0	CCC	CCC
G-F		0	JJ	DDD	GGG

G- K [1]	0	0	BBB	BBB
K-F	0	0	n/a	n/a
F-B	0	II	CCC	FFF

Thus, B paid $CCC and received $FFF, for a total of $II received. G paid $FFF and received $CCC, for a total of $LL paid. F paid $X and $FFF, and received $GGG, for a total received of $EE.

The incoming request proposed that, since no rent was paid, and no income was received, the rent expenses should be disallowed. Specifically, all claimed deductions for rental expense should be disallowed because the taxpayer participated in an elaborate scheme designed to create the legal appearance of a rental obligation, when the only interest being acquired was a future interest. It was stated that any amortization deduction should be disallowed because the taxpayer failed to establish a business purpose. Arguments can be made under the step transaction doctrine, that the transactions are shams, and that the transactions were carried out for the principal purpose of evading or avoiding Federal income tax under section 269.

LAW AND ANALYSIS:

In Notice 95-53, 1995-2 C.B. 334, the Service discusses “lease strips” or “stripping transactions” and the tax consequences of these transactions. In this Notice, the Service announced that the following authorities may apply to a stripping transaction: (i) sections 269, 382, 446(b), 701, or 704, and the regulations thereunder; (ii) authorities that recharacterize certain assignments or accelerations of future payments as financings; (iii) assignment-of-income principles; (iv) the business-purpose doctrine; or (v) the substance-over-form doctrines (including the step transaction and sham doctrines).

Sham

We agree with District Counsel’s assessment of the transactions as shams and conclude that this is the strongest argument in this case.

When a transaction is treated as a sham, the form of the transaction is disregarded in determining the proper tax treatment of the parties to the transaction, and the transaction will be taxed according to its substance. A transaction cannot be treated as a sham unless it is shaped solely by tax avoidance considerations.

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[1] This number represents the sum paid by G to K under the GIA. K was to pay rent to F on behalf of G.

Rice's Toyota World v. Commissioner, 752 F.2d 89, 92 (4th Cir. 1985); Frank Lyon Co. v. United States, 435 U.S. 561 (1978).

However, courts will respect the taxpayer's characterization of the transactions if there is a bona fide transaction with economic substance, compelled or encouraged by business or regulatory realities, imbued with tax-independent considerations, and not shaped solely by tax avoidance features that have meaningless labels attached. See Frank Lyon, 435 U.S. at 583-584.

To demonstrate that the transaction is a sham, the Service must show either that the taxpayer was motivated by no substantial business purpose other than obtaining tax benefits or that the transaction did not have any economic substance. All of the facts and circumstances surrounding the transactions must be considered, and no single factor is determinative.

Under the sham transaction analysis, the taxpayer must demonstrate that it had a subjective business purpose other than tax avoidance for engaging in the transaction. Casebeer v. Commissioner, 909 F.2d 1360, 1363 (9th Cir. 1990). The lower court in Casebeer had examined such factors as the parties' experience in computer leasing transactions, their inquiry into the market value and residual value of the equipment, and their trial testimony regarding their motivation for entering into the transaction. The appellate court found no clear error in the lower court's analysis of these factors, and affirmed the determination that the transactions did not possess business purpose.

Other factors under the business purpose analysis include the extent of investigation into the residual values by the parties' professional advisors, the parties' professed motivation for entering into the transactions, whether the advertising material used to promote the transactions emphasized the tax benefits over the economic benefits, and whether the activities were conducted in a businesslike manner. Achievement of a large tax benefit as the sole motivation is not a business purpose.

The taxpayer must also demonstrate that it had an objective economic substance apart from the beneficial tax consequences. Casebeer, 909 F.2d at 1365; Gilman v. Commissioner, 933 F.2d 143, 148 (2d Cir. 1991). The lower court in Casebeer had compared the parties' potential economic return with the investment in the transaction. A return that does not exceed the investment is an indication that there is no economic substance. Casebeer, 909 F.2d at 1366. The court upheld the lower court's holding that the transactions were shams.

Two additional factors under the economic substance analysis are whether a reasonable sales price and residual value of the equipment were established.

The Third Circuit recently decided in ACM v. Commissioner, No. 97-7527, 1998 U.S. App. LEXIS 25726 (3d Cir. Oct. 13, 1998), that a partnership taxpayer's contingent installment sale transaction, when viewed as a whole, did not possess the objective economic substance and subjective business purpose, and therefore the entire transaction was a sham. The ACM case involved a complex series of transactions structured to take advantage of the ratable basis recovery rule of section 453 and the regulations under Temp. Treas. Reg. § 15a.453 to create a mismatch of income and deductions, with over $100 million of gain distributed to a foreign partner and subsequently $80 million in losses distributed to a U.S. partner, a large U.S. corporation. The partner receiving the losses had contributed $35 million to the partnership.

The appellate court determined that the Tax Court properly denied the taxpayer's capital gain and most of its loss deductions. The appeals court reversed the Tax Court on one issue, and allowed the taxpayer to deduct losses pursuant to its ownership of certain LIBOR notes because the taxpayer's ownership of the notes had significant non-tax economic effects and the transaction was separable from the sham aspects of the underlying transaction.

Under section 162(a)(3), a taxpayer is allowed certain deductions, and it reads as follows, in relevant part:

> There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including-
> (3) rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

The Court in INDOPCO, Inc. v. Commissioner, 503 U.S. 79 (1992), reiterated the qualifications for deduction under section 162(a). To be deducted, an item must "'(1) be paid or incurred during the taxable year, (2) be for 'carrying on any trade or business, (3) be an expense, (4) be a necessary expense, and (5) be an ordinary expense.'" INDOPCO, 503 U.S. at 85 (internal citations omitted).

"It is well established that the existence of a genuine profit motive is the most important criterion for the finding that a given course of activity constitutes a trade or business." Lamont v. Commissioner, 339 F.2d 377 (2d Cir. 1964) (finding that taxpayer's expenses incurred in publishing activity were not deductible under section 162 because they did not constitute a trade or business with the intent of realizing a profit).

In Bealor v. Commissioner, T.C. Memo. 1996-435, the Tax Court denied taxpayers' section 162 deductions (payroll expenses) because the transactions giving rise to the deductions had neither economic substance nor a profit objective. This case involved a series of employee leases conducted by a series of related partnerships. The court determined that the transaction was a "classic circle transaction" to which it refused to give effect.

This transaction has many distinct parts: the A - D lease, the A - F lease and the subsequent circle of leases. The facts of this case support the use of the sham transaction doctrine applied to the transaction and the subsequent circle of leases, when looking at the transaction as a whole and to the individual transactions.

The facts indicate that the entire transaction encompassing the circle of leases has no business purpose. It appears that the parties inquired into the residual value of the equipment when it had R appraise the equipment; however, it is not known whether the appraisal was realistic. We do not know whether the parties involved were experienced in computer leasing transactions and were therefore able to make sound business judgments based on one appraisal. There are no legal opinions available for this transaction, which indicates that the parties did not rely on the advice of professional advisors.

All of these leases were purportedly entered into (although many were not executed) on the same day or in the same month of DATE 3. Most of the leases used the same language. The parties acknowledged in the leases that the leases were interrelated.

The materials from Q to O promoted the tax benefits of the transaction, which indicates a lack of business purpose. The Summary of the Equipment Lease Transaction by Q states that its proposed transaction would provide, upon an investment of $QQ, "pre-tax economics" of $WW, with a difference between the two of $NN. According to Q's estimation, this would yield tax deductions of approximately $HHH million, for a tax savings of $EEE.

There is evidence that the parties failed to act in a businesslike manner, evidence of a lack of business purpose. G and subsequently M failed to pay the $HH in initial rental payments that they were obligated to pay; however, N apparently paid this sum to F in satisfaction of the initial rental payment, but not until a later date. It is not businesslike to fail to make payments without incurring additional interest payments or penalties. The A - F lease and leaseback does not provide for rent payments from F to A; this is not a businesslike lease transaction.

The facts of this transaction indicate that it possessed no economic substance. F, G, B and K participated in a circle of leases with a circular flow of money. F, which leased the equipment from A, leased the equipment to G, which then leased the

equipment to B. B then leased the equipment back to F. The money originated with B when it prepaid "rent" to G. G purchased the GIA from K, and K was supposed to pay rent to F (as the lessor) on behalf of G. Finally, F was to pay rent to B. No payments were apparently made to A, the party believed to be either the owner of the equipment or the primary lessor. Thus, aside from the payment of any fees and the interest on the GIA, the money circled among B, G, K, F, and back to B.

F did not pay rent to A pursuant to the A-F lease and leaseback, however. F was required to pay A a fee of only $X. This nearly gratuitous lease assignment possesses no economic substance, especially when considering what the other parties "paid" for the leases.

It appears that the profit expected in this transaction (the excess of income over expenditures) was to be made from the SRA and from the interest on the GIA. We have no evidence as the income actually received from the SRA. N's income from the GIA was $GG in YEAR 1, $FF in YEAR 2, and $DD in YEAR 3, totaling $OO2. This is significantly less than the $YY in deductions for these same years. Although N's interest income on the GIA may have exceeded its up-front payment of $KK (for which it actually received LLL shares of M), N's expected deductions by far exceeded any economic return (i.e., profit).

N entered into this transaction knowing that it would receive no economic benefit from the rent payments because the rents paid out by G, its successor, equaled the rents G received. The success of this transaction relied on the residual value of the equipment from payments made under the SRA, and interest income from the GIA. If the values were not realistic, then there would be little, if any, residual value of the equipment from which the parties (G and then M and then N, through the SRA) could benefit economically. N knew (or should have known) about this because the lease agreements were signed on either the same day or within a short time of each other. Most of the leases contain similar language. Furthermore, Q sent a letter to N's parent, O, on DATE 7, in what appears to be a solicitation, providing the general outline for the transaction. N was not involved in this transaction until after it organized M on DATE 8, when M acquired G's assets on DATE 9.

In addition, the individual transactions within the larger transaction did not possess business purpose or economic substance, and are therefore shams. The lease from A to F and the subsequent leaseback to A from F appears to be a sham. A was already leasing the equipment to D, and D was leasing the equipment to E which was apparently using the equipment. A subsequently subleased the equipment to F but this transaction had no substance because A had nothing to lease to F. The terms of the lease state that A "shall let" and F "shall hire the machines," and that delivery of the equipment and acceptance of the equipment shall take place on a specified date. F never took delivery. It appears that the

lease is not a bona fide lease because there was no rent provided for, no delivery of equipment, there was no real lease of the equipment because the leases in this circle began and ended with F, they were all interdependent, and the leases were executed simultaneously or shortly after.

F paid a fee of $X, but paid no rent to lease the equipment from A. When A leased back the equipment from F, that leaseback also provided for no rent. This nearly gratuitous lease-leaseback arrangement lacks economic substance. All subsequent leases of the equipment are therefore without any economic substance or business purpose.

F failed to lease any computer equipment from A; therefore, F's subsequent purported lease to G, and all leases thereafter, lack substance, because F had nothing to lease. When G transferred its interests to M and subsequently to N, G transferred nothing of substance because G had nothing to transfer. Additionally, when G leased the equipment to B, this lease possessed no substance, because G had nothing to lease. Finally, the lease from B to F was lacking in substance because B had no lease to transfer.

B' prepayment of rent to G is a sham because B was not actually leasing anything of substance, there appears to be no business purpose and there was no economic benefit to the transaction. B never truly leased the equipment and never had any interest in the equipment. Therefore, B' payment to G is not a prepayment of rent.

K's payment of rent to F on behalf of G is a sham because there appears to be no business purpose and there was no economic benefit to the transaction. G never had any interest in the equipment because G was leasing from F, which had no real interest in the equipment, indicating a lack of business purpose. G would have benefitted economically only if it received income under the SRA, the income from which was dependent upon the accuracy of projected residual values of the equipment at issue. Furthermore, any economic benefit that G's initial partners could have received they never did because the income from the GIA was received by M and subsequently N.

F's payment of rent to B is a sham because the transaction, like its predecessors, lacks business purpose and economic substance. F was leasing the equipment from A, but then leased the equipment to G, only to lease it back from B. All of this occurred on nearly the same day, under leases with very similar language. This circle of leases does not appear to possess a business purpose. The economic substance is also questionable, because the subsequent leases simply add transactional costs and additional parties without the ability for an additional financial return.

Section 162 requires, as indicated above, that the expenses for which there is a deduction must be ordinary, necessary and for carrying on of a trade or business with a profit motive. N's deductions for YEAR 1, YEAR 2 and YEAR 3, total $YY. This is far greater than the income it received from the GIA, a total of $OO2, minus the expenses that it paid, or at least $KK. This belies any profit. Entering into a trade or business for the purpose of generating tax deductions, as it appears G and N have done, is not a business purpose that satisfies the trade or business requirements of section 162(a). Therefore, N's deductions for rent should be denied.

The deduction for the amortization of the initial rental payments which were paid by N on behalf of M should be disallowed because the underlying rental payments possess no economic substance. G was originally obligated to pay $JJ, which was renegotiated down to $HH in the Amendment to the SRA. M subsequently became obligated to make this payment, but also failed to pay. N, however, paid this amount when it agreed to subscribe to an additional LLL shares of M.

This case at hand resembles the transactions in Bealor in that money moves in a circle, and the transactions supporting the deductions possess neither business purpose nor economic substance; likewise, the deductions should be denied.

Sham Partnership

In order for a federal tax law partnership to exist, the parties must, in good faith and with a business purpose, intend to join together in the present conduct of an enterprise and share in the profits or losses of the enterprise. The entities' status under state law is not determinative for federal income tax purposes. Commissioner v. Tower, 327 U.S. 280, 287 (1946); Luna v. Commissioner, 42 T.C. 1067, 1077 (1964). The existence of a valid partnership depends on whether: considering all of the facts—the agreement of the parties, the conduct of the parties in execution of its provisions, their statements, the testimony of disinterested persons, the relationship of the parties, their respective abilities and capital contributions, the actual control of income and the purposes for which it is used, and any other facts throwing light on their true intent–the parties in good faith and action with a business purpose intended to join together for the present conduct of an undertaking or enterprise. Commissioner v. Culbertson, 337 U.S. 733, 742 (1949); ASA Investerings Partnership v. Commissioner, T.C. Memo. 1998-305; Rev. Rul. 82-61, 1982-1 C.B. 13.

In ASA Investerings, the primary issue considered by the Tax Court was whether AlliedSignal, Allied Signal Investment Corporation, Barber Corporation N.V., and Dominguito Corporation, N.V. formed a valid partnership for Federal income tax purposes. The Tax Court held that the corporations did not. The court disregarded the existence of Barber and Dominguito because the facts demonstrated that those

entities were agents for ABN, the lender. The court pointed out several relevant facts. First, both Barber and Dominguito were thinly capitalized shell corporations established for the sole purpose of engaging in the venture. Second, the parties treated ABN as the real participant in the venture and disregarded Barber's and Dominguito's respective corporate forms. As an example, AllliedSignal paid ABN directly for Barber's and Dominguito's participation in the venture. Third, Barber and Dominguito were mere conduits. ABN lent Barber and Dominguito the funds for their respective "capital contributions" and retained options that allowed ABN to purchase Barber's and Dominguito's shares for a de minimis amount. All of Barber's and Dominguito's profit from the transactions came back to ABN.

The court also concluded that because ASIC is AlliedSignal's wholly-owned subsidiary, AlliedSignal, not ASIC, is the relevant party. So for purposes of deciding the issue, the court also ignored the existence of ASIC. The court then considered whether AlliedSignal and ABN intended to join together in the present conduct of an enterprise.

The court pointed out the following facts as relevant to reaching its conclusion that AlliedSignal and ABN did not intend to join together in the present conduct of an enterprise. First, AlliedSignal and ABN had divergent business goals. AlliedSignal entered into the venture for the sole purpose of generating capital losses to shelter an anticipated capital gain. In pursuing this goal, AlliedSignal chose to ignore transaction costs, profit potential, and other fundamental business considerations. AlliedSignal focused solely on the potential tax benefits. In contrast, ABN entered into the venture for the sole purpose of receiving its specified return. This return was independent of the performance of ASA's investments (e.g., the profitability of the LIBOR Notes) and the success of the venture (i.e., whether AlliedSignal succeeded in generating capital losses). Further, ABN did not have any profit potential beyond its specified return and did not have any intention of being AlliedSignal's partner. In essence, the arrangement did not put all of the parties "in the same business boat," therefore, "they cannot get into the same boat merely to seek * * * [tax] benefits." Culbertson, 337 U.S. at 754.

In ASA Investerings, the taxpayer argued that ASA should be respected as a bona fide partnership because the purported partners carefully followed partnership formalities. The court stated that such formalities may have created a partnership facade, but the conduct of AlliedSignal and ABN demonstrates that the private side agreement, not the partnership agreement, governed their affairs.

The court concluded that the characteristics of AlliedSignal and ABN's relationship are contrary to the characteristics of a bona fide partnership. AlliedSignal and ABN had divergent, rather than common, interests. Moreover, they did not share in the venture's profit and losses and did not comply with their partnership agreement when it conflicted with the Bermuda Agreement, their private side agreement. In

conclusion, the court stated that AlliedSignal, ASIC, and ABN's agents, Barber and Dominguito, did not have the requisite intent to join together for the purpose of carrying on a partnership and sharing in the profits and losses therefrom. Instead, further analysis revealed that AlliedSignal and ABN had a debtor-creditor relationship. Having concluded that ABN is in substance a lender, the court held that Barber and Dominguito were not partners in ASA and that the appropriate amount of gain relating to the sale of the floating-rate private placement notes (PPNs) and loss relating to the sale of the LIBOR notes should be allocated between AlliedSignal and ASIC.

In this case, it appears that G was organized for the sole purpose of providing a vehicle to strip the rental income from the rental deductions. The rental income flowed through G to the foreign partners. Subsequently, M acquired an interest in the subleases and claimed its distributive share of the rental deductions that G reported on its Form 1065. In ASA Investerings, the court ignored the existence of Barber and Dominguito because they were considered mere agents of ABN. In this case, we would argue that the existence of G should be ignored because G it is a sham entity organized for the sole purpose of creating tax benefits for N and the other parties to this transaction and that there was no economic purpose for the existence of G. If we ignore the existence of G and the transactions G was a party to, then we are left with a lease transaction between the original lessor, A, and lessee, D. The transactions involving M and G are disregarded and, in disregarding those transactions, N's claimed deductions for rental expense are disallowed.

Recently, the Third Circuit, in ACM, applied an economic analysis to the transaction to conclude that the transaction lacked economic substance and, therefore, should not be respected for tax purposes. The Third Circuit stated that both the objective analysis of the actual economic consequences of ACM's transactions and the subjective analysis of their intended purposes must be considered. We believe that it is also important in determining whether an entity is a sham to do an objective analysis of the actual economic consequences of the transaction and a subjective analysis of their intended purposes. Under an objective analysis, it is important to determine whether any of the subleases involving G resulted in any economic gain to any of the parties. If G was formed solely to engage in transactions that lacked economic substance, then G lacked any economic purpose for its formation and, instead, G was formed solely as a vehicles to shift tax benefits from one party to another.

Section 269

The field has proposed several theories to attack the transaction, including section 269 and step transaction. We address each issue below.

Section 269 authorizes the Service to disallow any deduction or other allowance if any person or persons directly or indirectly acquire control of a corporation and the principal purpose for the acquisition is to evade or avoid Federal income tax by securing the benefit of a deduction or other allowance that such person or corporation would not otherwise enjoy.[2] Control is defined as the ownership of stock possessing at least 50 percent of the combined voting power of all shares entitled to vote or at least 50 percent of the total value of shares of all classes of stock of the corporation.

The acquisition requirement of section 269(a)(1) may be met even if the target corporation was newly incorporated by the taxpayer in a tax-free exchange under section 351. See Borge v. Commissioner, 405 F.2d 673 (2d Cir. 1968), cert. den. sub. nom. Danica Enterprises, Inc. v. Commissioner, 395 U.S. 933 (1969). In this case, N formed M On DATE 8, OOO days prior to the exchange at issue. Thus, N may argue that it did not acquire control of M in the exchange since it already controlled M. However, depending on the facts, the Service may be able to argue that the initial formation of M and the exchange at issue should be integrated. See, e.g., D'Angelo Associates v. Commissioner, 70 T.C. 121 (1978) acq. in result, 1979-2 C.B. 1. In that case, the Service can argue that N acquired control of M for purposes of applying section 269(a)(1).

Assuming the requirements of section 269(a)(1) are met, section 269 applies only if the tax evasion or avoidance purpose outranks or exceeds in importance any other single purpose for the acquisition. VGS Corp. v. Commissioner, 68 T.C. 563, 595 (1977), acq. 1979-2 C.B. 2; S. Rep. No. 627, 78th Cong., 1st Sess. 59 (1943), 1944 C.B. 973, 1017. The burden is on the taxpayer to show substantial business purpose. United States Shelter Corp. v. United States, 13 Cl. Ct. 606 (1987). Once a taxpayer shows such a purpose, the Service may find proving a tax-avoidance motive difficult because the taxpayer's intent is a question of fact. Moreover, the existence of a tax-avoidance purpose does not prevent business reasons from predominating and preventing the Service from applying section 269.

Treas. Reg. § 1.269-3(b)(1) of the Income Tax Regulations states, in part, that a transaction in which a corporation with large profits acquires control of a corporation with prospective deductions and the acquisition is followed by such transfers or other action as is necessary to bring the deductions into conjunction with the income is ordinarily indicative of a principal purpose of tax evasion or avoidance in

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[2] Section 269(a)(2) applies when any corporation, in this case M, directly or indirectly acquires property from an unrelated corporation in a transaction in which the basis of the property carries over. However, in this case, M acquired the property from a partnership, G, not a corporation. Therefore, section 269(a)(2) does not apply to this case.

the absence of evidence to the contrary. A lease stripping transaction has the potential for bringing profits and deductions of different parties into conjunction where: (1) M is a new corporation created by N in a section 351 transaction, (2) M is a member of N's consolidated group after the transaction, (3) N's consolidated group has profits, and (4) M is entitled to lease expense deductions. Thus, the Service may be able to argue that a principal purpose for which the parties engaged in a lease stripping transaction is tax evasion or avoidance.

Where courts have found the prohibited motive, they have generally approved the Service's denial of losses attributable to the period before the acquisition. For example, the Tax Court has disallowed the benefit of losses generated both before and after the tainted acquisition. Zanesville Investment Co. v. Commissioner, 38 T.C. 406 (1962), rev'd, 355 F.2d 507 (6th Cir. 1964). However, the courts of appeals have split with respect to losses (other than built-in losses) incurred after the acquisition, although the majority apply section 269 to disallow post-acquisition losses. Compare R.P. Collins & Co. v. United States, 303 F.2d 142 (1st Cir. 1962), the Circuit to which this case is appealable; Borge, 405 F.2d 673; Hall Paving Company v. United States, 471 F.2d 261 (5th Cir. 1973); Luke v. Commissioner, 351 F.2d 568 (7th Cir. 1966) (deduction for post-acquisition operating losses denied under section 269 as tainted by taxpayer's unrelated tax avoidance purpose); Herculite Protective Fabrics Corp. v. Commissioner, 387 F.2d 475 (3d Cir. 1968) (sustaining disallowance of pre-acquisition losses but post-acquisition losses not barred by section 269). See also Zanesville Investment, 355 F.2d 507. As noted above, the First Circuit, to which this case is appealable, has held that the Service can apply section 269 to disallow post-acquisition losses.

Step Transaction Doctrine

The Field mentions the possibility of applying the step transaction doctrine, but does not include it as one of its recommended arguments. The step transaction doctrine is a rule of substance over form that treats a series of formally separate but related steps as a single transaction if the steps are in substance integrated, interdependent and focused toward a particular result. Penrod v. Commissioner, 88 T.C. 1415, 1428 (1987).

The step transaction doctrine, as described above, allows the Service to argue that certain economically meaningless steps of a transaction can be collapsed or ignored. The Field is considering whether the step transaction doctrine can be applied in this case to eliminate economically meaningless steps.

Guaranteed Income Agreement

Pursuant to the terms of the GIA, K was to: (1) invest the funds that it received from G in such a way as to produce funds equal to or greater than the amount received

(but if K should generate income in addition to what it is required to pay out, it is entitled to keep the funds); (2) to use the funds to pay any debt of G's, including G's debts to F; and (3) to submit to G the Rent Schedules indicating that rent had been paid. Thus, the issue with the GIA is whether, and when, G may deduct its payments made indirectly to F as rental expenses. The GIA may simply represent a contract for services for which G paid $W, or the GIA may represent something else, such as a debt obligation.

In this case, there is no evidence that G is "defeased" of its obligation to pay rent to F by its procurement of the GIA. The Agreement itself does not state that G is not liable in the case of nonpayment or default by K. Although the Instruction from G to K indicates that K is to discharge G of its obligations under the Rent Schedules, there is no evidence that G was, in fact, legally discharged.

The facts indicate that N, G's successor to the leases, deducted rental payments over three years, but not upfront when the GIA was purchased by G. Therefore, if the form of the GIA is respected then the tax effects may be respected.

This transaction individually may be a sham if the transaction was not created with a subjective business purpose or with economic substance. If this transaction is a sham, then the GIA may be disregarded. This transaction may also be viewed in context of the entire transaction, which, as indicated above, appears to be a sham. If K and G can prove that the GIA possesses economic effect, then the GIA may be allowed to stand and may be given economic effect.

Additional facts need to be developed with respect to the GIA and its tax consequences.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

[redacted] The sham transaction doctrine is highly fact specific and we recommend developing the facts and circumstances for the entire transaction to support its application, and obtaining supporting documents. Documents include correspondence, memoranda, analyses, notes, whether tangible or stored or transmitted electronically (computer) and any form of written material reflecting any oral communication, including notes of telephone conversations.

We advise fully developing the business purpose of the transaction, and recommend asking the following questions and obtaining the following documents:

1. What were the business reasons for all of the parties entering into this transaction? Obtain all documents and statements of all oral conversations detailing the business reasons for the transaction. The transaction includes the

initial lease from A to F, all subsequent leases between F, G and B, the purchase of the GIA, the SRA, and the creation of M.

2. The business purpose analysis includes an inquiry into the emphasis of tax benefits in any promotional materials, and we recommend obtaining information on the Q's promotions. Did Q guaranty that the deductions could be taken in YEAR 1 through YEAR 3, and promise that the transaction could be unwound or that the parties would receive refunds of their investments if they did not obtain the tax benefits? Request all guaranty agreements, and statements detailing any oral guaranty agreement. Request all promotional materials from Q to G, F, B, A and D, including all documents, brochures and advertising materials.

3. Request information on why M was formed. Was it formed for this transaction? What business does M conduct?

4. Request information on when N was formed? What business does N conduct?

5. Request information on when G was formed? What business does G conduct?

6. Request legal opinions from N's attorneys in the transaction, especially if they were used to market this transaction. If no legal opinions are available, request statements on why the legal opinions are not available.

7. Were the appraisals for the projected useful life of the computer equipment realistic?

8. Did N pay any fees to Q to enter into this transaction in addition to the $Y fee and the $Z fee for investment banking? Did any other party pay any fees to Q? How were these fees structured? Obtain all records of the fee payments, including bank records and wire transfers.

9. Whether the activities were conducted in a businesslike manner is relevant to the business purpose inquiry. Request insurance contracts concerning the equipment at issue. Which party paid taxes on the equipment?

10. Did G, M, A or another party file a security interest, such as a UCC Article 9 filing in the equipment at issue in any jurisdiction? Request copies of all filings.

11. Did G's foreign partners leave the partnership? Why did M become a partner in G? Obtain all of G's partnership agreements and amendments to agreements.

12. Was A the owner of the equipment? Did G have an equity interest in the equipment?

In developing the economic substance of the transaction, we recommend developing these facts and documents:

13. Request documents and testimony by G's partners' detailing their analyses of their expected rate of return on this transaction. This includes analyses of the original lease of equipment by G and the transfer of G's assets to M.

14. Request documents relating to G's partners', M's and N's calculations of the profit and risk potential. Request documents concerning the parties' policies and practices with respect to risk or profit guidelines in all transactions and specifically in leasing transactions.

15. Obtain the records from all transfers of cash, such as bank records or wire transfer records. This includes B' prepayment of rent, G's payments to K, K's payments to F, and F's rent payments to B. This includes all records from any additional fees paid.

16. Request documents and testimony from N employees who can explain why N invested in a transaction that provided deductions but only a remote potential for income, from the SRA and interest on the GIA?

17. Why was G to receive the residual value of the equipment after the expiration of the leases in YEAR 3? Was any other party to receive residuals?

18. Request documents from M and testimony from M employees who can explain why M entered the G partnership as a partner when the rent payments received from B to G were already distributed - and the money went up to K for the GIA? Request information and testimony from M employees on the economic substance of this transaction.

19. Why did F pay no rent to A? What was the purpose of this lease arrangement? How was the fee that F paid structured?

Additional facts and documents to obtain include the following:

20. Provide the names of all former and current Q employees who were involved in this transaction, and include the job title, department, telephone numbers and addresses.

21. Provide the names of all former and current N employees who were involved in this transaction, and include the job title, department, telephone numbers and addresses. Provide the names of all former and current M employees who were involved in this transaction, and include the job title, department, telephone numbers and addresses.

22. Provide the names of all former and current G employees who were involved in this transaction and who dealt with Q, and include the job title, department, telephone numbers and addresses.

23. How did N amortize its payment of the initial rent as payment for an intangible asset? Were these capital expenses?

While the overall transaction may be a sham, the taxpayer could successfully argue that an individual transaction possesses economic substance and its tax consequences may not be disregarded. See ACM; Rice's Toyota, 752 F.2d at 96. Therefore, we recommend developing the sham as it applies to the entire transaction and to each of the individual steps within the transaction, specifically the lease-leaseback between A and F, all of the subsequent leases, and the assignment to N.

Andantech v. Commissioner, No. 15532-98 (Sept. 21, 1998), was petitioned in the Tax Court, and concerns a lease stripping transaction that is similar to this case. Andantech has been made a coordinated Notice case in the National Office. Although the Andantech case cannot be relied upon, district counsel may wish to contact the Leasing ISP team to be apprised of developments in the case.

We recommend that Examination develop whatever objective facts they can to support disallowing the rental deductions to N on the grounds that G is a sham partnership and, therefore, all transactions entered into by G must be disregarded for purposes of determining entitlement to the rental deductions. It is also important to develop facts to support the subjective intent of the parties and develop the facts to determine whether there was any useful non-tax purpose for the formation of the partnership.

If this case is transferred to Appeals, we recommend that the appeals officer contact the ISP Leasing team to discuss settlement issues based upon litigating hazards. Further, if the taxpayer pursues a legal forum for resolution of this issue and petitions the Tax Court, we recommend that district counsel contact the ISP Leasing team and the ISP National Office coordinator on the Leasing team.

To support its argument that N acquired control of M for purposes of applying section 269(a)(1), the Service would need to know what activities, if any, M engaged in during the OOO days between its formation and the exchange at issue. If, as appears to be the case, M was formed with nominal consideration and engaged in no significant activities during this OOO day period, the Service would have a strong argument that the formation and exchange should be integrated. In that case, as noted above, the Service can argue that N acquired control of M for purposes of applying section 269(a)(1).

However, the taxpayer may argue that the meeting of M's Board of Directors meeting on DATE 8a, authorizing M to enter into the Subscription Agreement is an independent act that prevents the Service from treating the DATE 8 and DATE 9 contributions as part of one transaction. Although this argument would pose a hazard, we do not believe it should preclude the Service from raising section 269 in this case.

Before we can comment on whether the step transaction doctrine applies in this case, we would need to know exactly how the field proposes to recharacterize the lease stripping transaction. In other words, we would need to know the specific steps that the field believes occurred in substance.

There are some litigating hazards in making this argument; however, an emphasis on the overall lack of economic substance may reduce the litigating hazards. If this doctrine can be applied, district counsel may wish to consider whether there is any substance to any of the individual transactions beyond the A - D / E lease.

[redacted] We recommend establishing the facts and circumstances surrounding this transaction to determine whether the GIA is a contract for services, something else (perhaps a debt instrument) or simply a sham. Such facts include the following:

1. How did the parties treat the GIA? How did G report the interest from the GIA for tax purposes?

2. Are there any amendments to the GIA or any additional agreements?

3. Did F agree to G's irrevocable instruction for K to discharge G's obligations? Was G still obligated to pay rent to F in the event that K failed to pay or defaulted?

4. Did K take any rental deductions for payments made pursuant to the GIA?

5. Confirm that N took into income the interest from the GIA.

We recommend developing the business purpose in obtaining the GIA.
6. What was G's professed motivation for obtaining the GIA? Obtain documents and testimony from G's partners and employees concerning the reasons.

We recommend developing the economic substance of the GIA.
7. Obtain documents and testimony from G's and K's partners and employees concerning their expected economic benefit on the GIA.

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